

Message Text

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FM AMEMBASSY LISBON
TO SECSTATE WASHDC PRIORITY 2233

C O N F I D E N T I A L SECTION 1 OF 3 LISBON 5502

E.O. 11652: GDS
TAGS: PINT, EFIN, PO
SUBJ: US OPTIONS FOR RESPONDING TO PORTUGUESE FOREIGN
EXCHANGE CRISIS

REF: LISBON 5345

THE FOLLOWING OPTIONS PAPER IS SUBMITTED PURSUANT TO
DEPARTMENT'S REQUEST.

1. THE PROBLEM: BECAUSE OF A HEAVY, UNANTICIPATED
LATE JUNE AND EARLY JULY OUTFLOW, PORTUGUESE FOREIGN
EXCHANGE RESERVES HAVE FALLEN TO DANGEROUSLY LOW LEVELS.
AVAILABLE EXCHANGE IN INSUFFICIENT TO COVER OBLIGATIONS.
DISBURSEMENT UNDER THE LARGE LOAN OFFERS NO RELIEF UNTIL
OCTOBER AT THE EARLIEST. AT THE CURRENT RATE OF DEFICIT,
THE JUST-CONCLUDED \$100 MILLION BIS SHORT-TERM LOAN AND A
\$50 MILLION ESF DRAWING SHOULD PROVIDE LIQUIDITY THROUGH
MID-AUGUST. THE CRUNCH MIGHT BE FURTHER PUT OFF UNTIL
THE END OF AUGUST IF TOURISM RECEIPTS AND IMMIGRANT
REMITTANCES INCREASE AS EXPECTED. SHOULD PAYMENTS OF
SHORT-TERM CREDITS TO FINANCE IMPORTS BE THE PRINCIPAL
CAUSE OF CURRENT HEAVY OUTFLOWS, AS CENTRAL BANK
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GOVERNOR SILVA LOPES SUSPECTS, PRESSURES COULD EASE
SLIGHTLY IN AUGUST BUT WOULD WORSEN MARKEDLY IN SEPTEMBER
GIVEN LOWER FEBRUARY IMPORTS AND MASSIVE MARCH IMPORTS.

2. AN OPENING CAVEAT: OUR REACTION TO PORTUGAL'S
LOOMING FOREIGN EXCHANGE CRISIS WILL BE CONDITIONED BY
THE PORTUGUESE RESPONSE. WE STILL DO NOT HAVE THE GOP

ANALYSIS OF THE CAUSES OF THE CRISIS AND SPECIFICS ON HOW THE GOVERNMENT PLANS TO DEAL WITH IT. UNTIL WE DO, AN EXAMINATION OF THE POLITICAL IMPLICATIONS OF OUR OPTIONS WILL BE INCOMPLETE AND CONCLUSIONS ONLY TENTATIVE.

3. ASSUMPTIONS:

(A) FOR STRUCTURAL AND DEVELOPMENTAL REASONS, EXCHANGE PROBLEMS WILL CONTINUE TO BE SERIOUS THROUGH THE MID-TERM; THE CURRENT PROBLEM IS SHORT-TERM.

(B) THE GOVERNMENT WILL SURVIVE THE CURRENT LEGISLATIVE CRISIS AND LAWS ESSENTIAL FOR ECONOMIC RECOVERY WILL BE PASSED.

(C) THE GOVERNMENT IS PREPARED TO TAKE EVEN MORE DRASTIC MEASURES BUT WILL STOP SHORT OF THOSE WHICH WOULD SPLIT THE SOCIALIST PARTY OR PRODUCE MASSIVE SOCIAL UPHEAVAL.

(D) ANY COURSE OF ACTION THE GOP TAKES IS UNLIKELY TO TAKE EFFECT RAPIDLY ENOUGH TO COVER FULLY THE SHORT-TERM FOREIGN EXCHANGE GAP.

(E) NEITHER CURRENT DISCUSSIONS WITH THE IMF NOR EFFORTS TO ACCELERATE DISBURSEMENTS OF THE LARGE LOAN ARE LIKELY TO PRODUCE TIMELY RELIEF.

4. USG OPTIONS:

(A) DO NOTHING. LEAVE IT TO THE PORTUGUESE TO PUT THEIR HOUSE IN ORDER. WE CAN ARGUE, WITH CONSIDERABLE CONFIDENTIAL

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JUSTIFICATION, THAT WE HAVE ALREADY DONE MORE THAN OUR SHARE AND THAT MORE HELP ONLY ENCOURAGES DEPENDENCY.

(B) PRESS THE EUROPEANS TO PROVIDE WHATEVER SHORT-TERM ASSISTANCE IS NEEDED. PORTUGAL IS MORE A EUROPEAN THAN A U.S. PROBLEM.

(C) PROVIDE ASSISTANCE ONLY IF THE GOP TAKES DRASTIC ECONOMIC MEASURES TO PRODUCE AN IMMEDIATE TURNAROUND. BASE OUR DECISION PRINCIPALLY ON ECONOMIC CRITERIA. CONSIDER GOP PROPOSALS FOR DEALING WITH THE LOOMING CRISIS AS THE POINT OF DEPARTURE FOR DEMANDING MORE. INSIST UPON SPECIFICS -- E.G. A SUBSTANTIAL DEVALUATION IN THE 25-30 PERCENT RANGE, DRAMATIC INCREASE IN INTEREST RATES, TIGHTER BUDGET AND INCOMES POLICIES, ETC. -- ON THE GROUNDS THAT ANYTHING LESS WILL BE INEFFECTIVE. REFUSE TO PROVIDE SHORT-TERM HELP UNLESS THESE CONDITIONS ARE MET.

(D) PROVIDE ASSISTANCE IF THE GOP RESPONSE REFLECTS A RESOLVE TO DEAL WITH THE UNDERLYING CAUSES OF THE CRISIS. BUT IN DECIDING HOW MUCH IS ENOUGH, BALANCE ECONOMIC CRITERIA WITH POLITICAL AND SOCIAL CONSIDERATIONS. PRESS HARD, BUT BE PREPARED TO ACCEPT SOMETHING CLOSE TO THE PORTUGUESE JUDGEMENT AS TO WHAT THE POLITICAL MARKET

WILL BEAR. WORK CLOSELY WITH IMF.

5. POLITICAL IMPACT:

(A) OPTION NO. 1: DO NOTHING.

IN THE SHORT TERM:

-- IT MIGHT STIMULATE THE GOVERNMENT TO ENACT TOUGH MEASURES ON ITS OWN.

-- WITH NO HELP, THE GOVERNMENT MIGHT DEFAULT ON ITS OBLIGATIONS, FEEDING OPPOSITION ASSERTIONS OF GOVERNMENT INCOMPETENCE.

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FM AMEMBASSY LISBON

TO SECSTATE WASHDC PRIORITY 2234

C O N F I D E N T I A L SECTION 2 OF 3 LISBON 5502

-- DEFAULTS WOULD RUIN PORTUGAL'S CREDIT STANDING.
-- INVESTOR CONFIDENCE WOULD BE HURT AND ECONOMIC RECOVERY DELAYED.

-- IT WOULD BE VIEWED AS A VOTE OF NO-CONFIDENCE IN THE SOARES GOVERNMENT.

-- IT WOULD CONTRIBUTE TO THE POSSIBLE FALL OF THE GOVERNMENT OR ITS SUBSTANTIAL MODIFICATION.

IN THE LONGER TERM:

-- OPPOSITION PRESSURE WOULD INTENSIFY AS EFFECTS OF THE CRISIS WERE FELT.

-- THE CURRENT OR SUCCESSOR GOVERNMENTS WOULD HAVE TO ADOPT MORE STRINGENT AUSTERITY MEASURES AS THE CRISIS DEEPENED. NASCENT DEMOCRATIC INSTITUTIONS WOULD BE PUT UNDER UNBEARABLE PRESSURE.

(B) OPTION NO. 2: PRESS THE EUROPEANS.

IN THE SHORT TERM:

-- IT WOULD BE INTERPRETED AS A USG REFUSAL TO HELP.

-- IT MIGHT PRODUCE SOME SECOND THOUGHTS REGARDING COMMITMENTS ACCEPTED IN PARIS.

-- IT WOULD PROBABLY PRODUCE NO MORE MONEY FOR PORTUGAL. THE EUROPEANS WOULD ARGUE THEY HAVE DONE FAR MORE THAN WE HAVE, INCLUDING PROVIDING \$100 MILLION TO DEAL WITH THE CURRENT CRISIS.
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IN THE LONGER TERM:
-- US WITHDRAWAL FROM THE SCENE MIGHT EVENTUALLY FORCE THE EUROPEANS TO DEAL MORE FULLY WITH THEIR OWN PROBLEMS.
-- A FAILURE OF THE PORTUGUESE EXPERIMENT WOULD HAVE ADVERSE REPERCUSSIONS IN NATO AND SOUTHERN EUROPE.
(C) OPTION 3: DEMAND MORE.

IN THE SHORT TERM:
-- PRESSURES WOULD BE RESISTED BY THE GOVERNMENT. THE DETAILS WOULD INEVITABLY BECOME KNOWN. OUR PRESSURES WOULD BE CITED AS EVIDENCE OF OUR REVERSION TO TYPE, AND OUR RELATIONS WITH THE GOP WOULD DETERIORATE.
-- IF THE GOVERNMENT WENT ALONG, IT WOULD BE SUBJECTED TO IRRESISTABLE PRESSURES FROM BOTH LEFT AND RIGHT FOR GIVING IN TO FOREIGN DEMANDS. THE PCP, IN PARTICULAR, WOULD EXPLOIT OUR PRESSURES TO INCREASE ITS INFLUENCE WITH THE WORKERS AND ESCALATE ITS ANTI-GOP OFFENSIVE.
-- THE GOVERNMENT MIGHT RESIGN OR BE VOTED OUT. THE RESULTING POLITICAL INSTABILITY WOULD SET BACK THE ECONOMIC RECOVERY PROGRAM.

IN THE LONGER TERM:
-- THE POSITIVE ECONOMIC EFFECTS OF STRONG MEASURES, BY PROMOTING RECOVERY, MIGHT CALM SOCIAL TENSIONS.
-- ON THE OTHER HAND THE POLARIZATION WHICH WILL INEVITABLY FOLLOW A GOVERNMENTAL SHIFT TO THE RIGHT (COALITION OR PSD/CDS GOVERNMENT) WOULD INCREASE SOCIAL TENSIONS.
-- THE SOCIALISTS, OUT OF THE GOVERNMENT, WOULD BE PUSHED TOWARD THE COMMUNISTS.
-- MODERATE LEADERSHIP WITHIN THE PS WOULD BE DAMAGED. THE LEFTWINGERS, CHANTING WE TOLD YOU SO, WOULD AGAIN BECOME A FORCE WITHIN THE PARTY. EVENTUAL SCHISM WITHIN THE PS WOULD FEED COMMUNIST STRENGTH.

(D) OPTION NO. 4: SYMPATHETIC UNDERSTANDING.
IN THE SHORT TERM:
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-- OUR FUNDS WOULD STRENGTHEN THE GOVERNMENT'S HAND BY CUSHIONING THE IMPACT OF THE CRISIS.
-- ADDITIONAL MEASURES WOULD BE TAKEN BUT THEY WOULD BE IMPLEMENTED AT THE PACE DEEMED POLITICALLY ACCEPTABLE BY THE SOCIALISTS.

-- THE OPPOSITION WOULD STEP UP ITS ATTACKS ON
THE GOP FOR MORTGAGING THE COUNTRY'S FUTURE. OUR LOANS
COULD BECOME A LARGER POLITICAL ISSUE THAN THEY NOW ARE.
-- IT WOULD REINFORCE THE VIEW IN SOME CIRCLES THAT
THE PS AND THE USG ARE SYNONYMOUS.
-- DEPENDING ON THE NATURE OF THE CRISIS WE MIGHT
ONLY BE POSTPONING THE INEVITABLE.
IN THE LONGER TERM:
-- IT WOULD INCREASE OUR STAKE IN THE PORTUGUESE
DEMOCRATIC EXPERIMENT. WE WOULD IN EFFECT BE UPPING THE
ANTE, BUT STILL GAMBLING ON OVERALL SUCCESS.

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TO SECSTATE WASHDC PRIORITY 2235

C O N F I D E N T I A L SECTION 3 OF 3 LISBON 5502

-- ECONOMIC RECOVERY WOULD PROCEED AT A SLOWER
PACE THAN IT MIGHT IF THE GOP TOOK THE DRASTIC MEASURES
IT WOULD BE OBLIGED TO TAKE NO ADDITIONAL FOREIGN SUPPORT
FORTHCOMING.

6. IMPACT ON U.S. INTERESTS: ALL OPTIONS EXCEPT 4
WOULD HAVE AN IMPACT ON THE AZORES NEGOTIATIONS, THE ROLE
THE GOP CAN PLAY IN AFRICA AND ITS ABILITY TO COOPERATE
WITH US IN INTERNATIONAL FORA. IF THE GOP FALLS, OR IF
RELATIONS WITH US BECOME STRAINED, THE AZORES NEGOTIATIONS
WILL INITIALLY BE DELAYED. IF THE RESULTING SOCIAL
TENSION PROPELS THE MILITARY INTO THE POLITICAL ARENA
AGAIN, THE US WILL HAVE SUFFERED A MAJOR POLICY SETBACK
JUST WHEN THE PERCEPTION IS GROWING THAT WE ARE WELL ON
THE WAY TO SUCCESS.

7. A PRELIMINARY CONCLUSION: THE ASSUMPTIONS MADE IN

PARAGRAPH 3 ARE CONTROLLING. WE SHOULD NOT MOVE UNTIL THE FACTS ARE IN.

8. BUT IF THE FACTS CONFIRM THE ASSUMPTIONS THEN WE NEED TO ACT. STRONG PRESSURE SHOULD BE PUT ON THE GOP, BUT SUCH PRESSURE MUST BE TEMPERED WITH POLITICAL REALISM. CONFIDENTIAL

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OPTION 4 IS RECOMMENDED; OPTION 2 IS A NON-STARTER; OPTION 1 IS INCONSISTENT WITH OUR PRESENT POLICY, AND OPTION 3 POSES UNACCEPTABLE RISKS.

9. WE SHOULD NOT FORGET THAT PORTUGAL IS A COUNTRY OF EIGHT MILLION PEOPLE WHO HAVE MADE THEIR CHOICE FOR WESTERN DEMOCRACY CLEAR IN REPEATED ELECTIONS. GIVEN ITS SIZE AND RECENT ENCOURAGING ECONOMIC INDICATORS THE DRAIN ON WESTERN RESOURCE WILL BE FINITE. THE COST OF FAILURE IN POLITICAL TERMS IS FAR HIGHER THAN THE EXTRA MARGIN OF SHORT-TERM INVESTMENT NEEDED TO GET OVER THE CURRENT HURDLE. CARLUCCI

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